Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Harman | Analyst: Marion Mann DeJong | Bill Number: AB 809

Related Bills: See Prior Analysis | Telephone: 845-6979 | Amended Date: 04/30/2003

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Apportionment of Business Income

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

__X__ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced February 20, 2003.

__X__ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO _____.

____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED _____. STILL APPLIES.

____ OTHER - See comments below.

SUMMARY

This bill would allow certain taxpayers to use an apportionment formula based heavily on sales rather than the standard apportionment formula used to determine the amount of business income taxable by California.

SUMMARY OF AMENDMENTS

The April 30, 2003, amendments narrowed the scope of the bill to allow only specified businesses to use the apportionment formula based heavily on sales and phased in the change to the formula over a two-year period.

The "Effective/Operative Date," "Federal/State Law," "Legislative History," "Program Background," and "Other States' Information" discussions in the department's analysis of the bill as introduced February 20, 2003, still apply. The remainder of the department's prior analysis is replaced with the following. The Board position remains pending.

PURPOSE OF THE BILL

The purpose of the bill appears to be to attract investment to the state by lowering state income taxes for companies within certain industries that have substantial investment in property and payroll in California relative to sales.

Board Position:			Legislative Director	Date
_____ S	_____ NA	_____ NP		
_____ SA	_____ O	_____ NAR	Jana Howard for Brian Putler	5/13/03
_____ N	_____ OUA	__X__ PENDING		

LSB TEMPLATE (rev. 6-98)

Summary of Suggested Amendments

Amendments are needed to resolve the implementation concerns discussed in this analysis. See "Implementation Considerations." Department staff is available to assist the author with these amendments. In addition, amendments are provided to resolve technical concerns identified by department staff and discussed with the author's staff. See "Technical Considerations" below.

ANALYSIS

THIS BILL

This bill would allow qualified taxpayers to use an apportionment formula based heavily on sales rather than the standard three-factor, double-weighted sales apportionment formula used to determine the amount of business income taxable by California. For the 2005 taxable year, the formula would be 75% sales, 12.5% property, and 12.5% payroll. For the 2006 taxable year and each year after, the formula would be based entirely on sales.

Qualified taxpayers would be defined as apportioning trade or businesses described in the following Principal Business Activity Codes prescribed by the Internal Revenue Service:

311900 – Other Food Manufacturing (including coffee, tea, flavorings, & seasonings)
325410 – Pharmaceutical & Medicine Manufacturing
333200 – Industrial Machinery Manufacturing
334110 – Computer & Peripheral Equipment Manufacturing
334410 – Semiconductor & Other Electronic Component Manufacturing
511210 – Software Publishers
541519 – Other Computer Related Services
512100 – Motion Picture & Video Industries (except video rental)

Qualified taxpayers that have a sales factor for the taxable year that is less than the average of their property and payroll factors, and **fail to meet both** of the following requirements, would be required to use the three-factor, double-weighted sales formula.

- Their average number of employees in California during the taxable year is at least 90% of the average number of employees employed in California during the preceding five taxable years; and
- Their percentage decline in the number of employees in California between the current and immediately preceding taxable year is less than or equal to any corresponding, cumulative percentage decline in all other states in which the taxpayer is engaged in business.

In other words, qualified taxpayers that have an average of property and payroll in California in excess of sales would use the heavily weighted sales formula **only if** certain employment requirements are maintained. If the employment requirements are not maintained, the qualified taxpayer must use the three-factor, double-weighted sales formula.

However, if the employment requirements were not maintained because of natural disaster or other act of God, an act of terrorism, or an action of federal, state, or local government, the taxpayer would use the heavily weighted sales formula.

Taxpayers that derive more than 50% of their gross business receipts from the following Principle Business Activity Codes would be allowed to **elect** either the heavily weighted sales formula or the three-factor, single-weighted sales formula.

211110 – Oil & Gas Extraction
324110 – Petroleum Refineries (including integrated)
424700 – Petroleum & Petroleum Products

The election must be made on a timely filed original return. This election would not apply to taxable years beginning prior to January 1, 2005. The one-time election of the apportionment formula would be made by contract with the Franchise Tax Board. The election may be terminated if the taxpayer is acquired by a larger nonelecting entity or with the permission of the Franchise Tax Board.

Taxpayers that derive more than 50% of their gross business receipts from either a savings and loan activity or a banking or financial business activity would be required to use the three-factor, single-weighted sales formula. (This is the formula that such businesses are required to use under current law.)

All other apportioning trade or businesses would be required to use the three-factor, double-weighted sales formula. (The formula that most businesses are required to use under current law.)

The bill would provide that if any part of the new apportionment formula provisions is found unconstitutional or is otherwise unenforceable, the remaining provisions would remain in force and effect.

IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation concerns:

- This bill provides a special apportionment formula for qualified taxpayers rather than qualified activities as in current law. In the case of a combined group, department staff is uncertain how it would be determined if the taxpayer were a qualified taxpayer. For example, if the members of a combined group include an industrial machinery member, software publishing member, and restaurant member, would the group as a whole be required to meet the principal business activity code to be a qualified taxpayer? Under current law, a combined group aggregates all of their gross receipts from qualified activities (e.g., agriculture, extracting, and financial) and then uses the sum of those receipts, compared to total receipts, to determine which apportionment formula to use. This issue could be resolved by modifying the definition of qualified taxpayer to specify that it is an apportioning trade or business that derives more than 50% of its gross business receipts from one of the listed activities.

- The principal business activity code is self-determined by taxpayers for federal statistical purposes. It is unclear whether the department could challenge whether the taxpayer chose the correct code.

- The employment tests for determining which apportionment formula would be used by qualified taxpayers could be complex when applied to complex taxpayer situations, such as water's-edge taxpayers. Such taxpayers would be required to identify the number of their employees whose compensation is used in determining the payroll factor. It is unclear how the tests would be applied in situations like Subpart F compensation that is normally included only in a ratio.

In addition, the tests do not provide complete rules for the sale or acquisition of members of a combined group. Although the bill specifies that the acquisition and disposition of entities is not considered for calculating the employment history of prior tax years, it is unclear whether they are considered for the current or future years. The tests will require an entity-by-entity tracking because if their groups have significant changes, subtraction of the historical members, member-by-member, will have to be done.

Furthermore, it is unclear whether adjustments to the base year for purposes of the employment comparison are required if the taxpayer makes a water's-edge election or returns to worldwide status.

Department staff is concerned that the employment tests could be onerous on taxpayers since they would be required to maintain and compare payroll records for at least five years. In addition, developing forms and instructions for the employment tests and auditing them would be difficult for the department. It is unclear whether the policy goals of rewarding taxpayers that maintain employment in California with continued use of the heavily weighted sales formula outweigh these implementation concerns.

- The bill provides exceptions to the employment test for an action of federal, state, or local government. Clarification of what constitutes an action of federal, state, or local government is needed to avoid disputes between taxpayers and the department.

- The election for taxpayers with specified extracting activities is accomplished by a one-time contract, similar to the water's-edge contract. Currently the Franchise Tax Board is supporting legislation to eliminate the water's-edge contract and replace the current contract with an election due to implementation issues caused by conflicts between contract law and tax law. The contract mechanism in this bill would have the same implementation concerns and should be changed to a simple election.

  In addition, the language of the election appears to be contradictory. It specifies that it is a "one-time election" to be made on the original return for "a year." This implies that the election can be changed each taxable year. The election should be clarified to ensure the bill is implemented as the author intended.

  Furthermore, the election procedures need to be clarified to address issues such as how members of a unitary group make the election and whether an election can be perfected or terminated.

- Existing provisions of law address whether invalid provisions may be severed. The bill specifies that if any part of the apportionment formula statute were found unconstitutional or unenforceable, the remaining provisions would remain in force and effect. It is unclear if the author intends something different than existing law. In addition, the bill does not specify the actual remedy.

TECHNICAL CONSIDERATIONS

The reference to subdivisions that provide exceptions to the heavily weighted sales formula for qualified taxpayers is incorrect. Subdivision (b) provides an exception. However, subdivision (d) would allow the heavily weighted sales formula if certain additional conditions are met. Amendments 1 and 9 would delete the reference to subdivision (d).

Amendments 2, 3, 5, 10, 11, and 13 would add "qualified" to the term taxpayer to provide consistency in the statute. Although the term "taxpayer" is used in the election provision, amendments were not provided to change that term to "qualified taxpayer" since staff believes the term should be "apportioning trade or business" and because staff has additional implementation concerns with the election provision. See "Implementation Considerations" above.

Amendments 4 and 12 would change "on action" to "an action."

Amendments 6 and 14 would delete an unnecessary definition that causes implementation concerns for apportioning trade or businesses that do not file combined reports (e.g., single entity taxpayers, partnerships). These amendments would also add the current law definitions of "savings and loan activity" or "banking or financial business activity" since these terms are used in the statute.

Amendment 7 would add a code that was inadvertently omitted.

Amendment 8 would extend the repeal date to 2006 so the transitional section (Section 2 of the bill) is repealed after the end of all 2005 fiscal years.

FISCAL IMPACT

If the bill were amended to resolve the implementation considerations discussed in this analysis, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Estimated Revenue Impact of AB 809 As Amended April 30, 2003 Effective for tax years Beginning on or After January 1, 2005 $ Millions			
2003-04	2004-05	2005-06	2006-07
-$0	-$15	-$85	-$165

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The revenue impact of this bill would be determined by the change in tax liabilities under the proposed apportionment formula as compared with the current law formula.

Samples of corporate tax returns for the 1999, 2000, and 2001 tax years were used for this estimate. For each corporation, tax liabilities were calculated under the current and the proposed apportionment formulas. The revenue impact was estimated as the difference between calculated tax liabilities. The impact for each corporation was statistically weighted and aggregated to derive an estimate of the total revenue impact for each of the sampled tax

years. It is assumed that 95% of corporations filing combined returns and having sales factors less than the averages of the other two factors would meet the employment tests. This assumption is based on an analysis of the relationship between California wages from the 1997, 1998, and 1999 corporate samples. The revenue impact of the proposal was calculated as the average of the three estimates. The impact was projected to future years using the growth in corporate profits as forecasted by the Department of Finance (December 2002).

The above estimated revenue losses are substantially lower than the estimated revenue losses for the bill as introduced on February 20, 2003. This is due to (1) the amended bill narrowed the focus of the bill to qualified taxpayers in selected business activities, and (2) the 2001 sample of corporate tax returns was used in this analysis. The 2001 sample was not available for the prior analysis. The 2001 sample produced lower estimated losses than those produced by earlier samples.

LEGAL IMPACT

There have been some concerns expressed in tax literature that a single-factor formula, or heavily weighted sales formula, might be unconstitutional if done with the intent to benefit local commerce. In general, a heavily weighted sales formula would benefit companies that are physically located in one state to the detriment of those located outside that state. An equally weighted three-factor formula has been the bench mark reflecting a reasonable sense of how income is generated in a state, while a heavily weighted sales formula is more readily subject to distortions in the market and therefore more likely to be subject to litigation.

Furthermore, it could be argued that the employment tests are unconstitutional because they cause taxpayers that shift some of their business to another state to lose the tax incentive.

ARGUMENTS/POLICY CONCERNS

This bill would allow taxpayers conducting extractive business activities to elect which apportionment formula to use. This bill could be considered inequitable to all other taxpayers since they are not allowed to choose the formula used.

Current law provides an exception to the use of the three-factor, double-weighted sales formula for corporations that derive more than 50% of their gross business receipts from agricultural, extractive, savings and loan, and banking and financial business activities. These corporations are instead required to use a three-factor, single-weighted sales formula because of the adverse impact on those industries by a formula that weighs sales more heavily than other factors. This bill would not provide an exemption from the more heavily weighted sales formula for agricultural activities.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 809
As Amended April 30, 2003

AMENDMENT 1

On page 4, line 30, strikeout "or (d)".

AMENDMENT 2

On page 5, line 6, before "taxpayer" insert:

qualified

AMENDMENT 3

On page 5, line 12, before "taxpayer" insert:

qualified

AMENDMENT 4

On page 5, line 16, strikeout "on" and insert:

an

AMENDMENT 5

On page 5, line 19, before "taxpayer" insert:

qualified

AMENDMENT 6

On page 7, strikeout lines 6 through 9, inclusive, and insert:

(4) "Savings and loan activity" means any activities performed by savings and loan associations or savings banks which have been chartered by federal or state law.

(5) "Banking or financial business activity" means activities attributable to dealings in money or moneyed capital in substantial competition with the business of national banks.

(6) "Qualified taxpayer" means an apportioning trade or

AMENDMENT 7

On page 7, line 11, after “334410,” insert:

511210

AMENDMENT 8

On page 7, line 23, strikeout “2005,” and insert:

2006,

AMENDMENT 9

On page 7, line 31, strikeout “or (d)”.

AMENDMENT 10

On page 8, line 8, before “taxpayer” insert:

qualified

AMENDMENT 11

On page 8, line 14, before “taxpayer” insert:

qualified

AMENDMENT 12

On page 8, line 18, strikeout “on” and insert:

an

AMENDMENT 13

On page 8, line 21, before “taxpayer” insert:

qualified

AMENDMENT 14

On page 10, strikeout lines 14 through 17, inclusive, and insert:

(4) “Savings and loan activity” means any activities performed by savings and loan associations or savings banks which have been chartered by federal or state law.

(5) “Banking or financial business activity” means activities attributable to dealings in money or moneyed capital in substantial competition with the business of national banks.

(6) “Qualified taxpayer” means an apportioning trade or